Auditing
Notes
B. Com 6th Semester
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Unit I

Introduction to Auditing

Meaning and Definition of Auditing

The word Audit is derived from Latin word "Audire" which means 'to hear'. Auditing is the verification of financial position as disclosed by the financial statements. It is an examination of accounts to ascertain whether the financial statements give a true and fair view financial position and profit or loss of the business. Auditing is the intelligent and critical test of accuracy, adequacy and dependability of accounting data and accounting statements. Different authors have defined auditing differently, some of the definition are:

"Auditing is an examination of accounting records undertaken with a view to establishment whether they correctly and completely reflect the transactions to which they purport to relate."**-L.R.Dicksee**

"Auditing is concerned with the verification of accounting data determining the accuracy and reliability of accounting statements and reports." **- R.K. Mautz**

"Auditing is the systematic examination of financial statements, records and related operations to determine adherence to generally accepted accounting principles, management policies and stated requirement." **-R.E.Schlosser**

Objectives of Auditing

The objectives of auditing are changing with the advancement of business techniques. Earlier it was only to check the correctness of receipts and payments. The objectives of the auditing have been classified under two heads:

1) Main objective
2) Subsidiary objectives

Main Objective: The main objective of the auditing is to find reliability of financial position and profit and loss statements. The objective is to ensure that the accounts reveal a true and fair view of the business and its transactions. The objective is to verify and establish that at a given date balance sheet presents true and fair view of financial position of the business and the profit and loss account

gives the true and fair view of profit or loss for the accounting period. It is to be established that accounting statements satisfy certain degree of reliability. Thus the main objective of auditing is to form an independent judgement and opinion about the reliability of accounts and truth and fairness of financial state of affairs and working results.

Subsidiary objectives: The subsidiary objectives of the auditing are:

1. Detection and prevention of fraud: the one of the important subsidiary objective of auditing is the detection and prevention of fraud. Fraud refers to intentional misrepresentation of financial information. Fraud may involve:
    a. Manipulation, falsification or alteration of records or documents
    b. Misappropriation of assets.
    c. Suppression of effect of transactions from records or documents.
    d. Recording of transactions without substance.
    e. Misapplication of accounting policies
2. Detection and prevention of errors: is another important objective of auditing. Auditing ensures that there is no mis-statement in the financial statements. Errors can be detected through checking and vouching thoroughly books of accounts, ledger accounts, vouchers and other relevant information.

Importance of Auditing

Importance of auditing can be judged from the fact that even those organizations which are not covered by companies Act get their financial statements audited. It has become a necessity for every commercial and even non- commercial organization. The importance of auditing can be summed in following points:

a. Audited accounts help a sole trader in knowing the value of the business for the purpose of sale.
b. Dispute over correctness of profits can be avoided.
c. Shareholders, who do not know about day-to-day administration of the company , can judge the performance of management from audited accounts.
d. It helps management in detecting and preventing errors and frauds.
e. Management gets advice on financial affairs from the auditors.
f. Long and short term creditors depend on audited financial statements while taking decision to grant credit to business houses.
g. Taxation authorities depend on audited statements in assessing the income tax, sales tax and wealth tax liability of the business.
h. Audited accounts are useful for the government while granting subsidies etc.
i. It can be used by insurance companies to settle the claims arising on account of loss by fire.
j. Audited accounts serve as a basis for calculating purchase consideration in case of amalgamation and absorption.
k. It safe guards the interests of the workers because audited accounts are useful for settling trade disputes for higher wages or bonus.

Types of audit

Based on ownership: On the basis of ownership audit can be:-

1. **Audit of Proprietorship:** In case of proprietary concerns, the owner himself takes the decision to get the accounts audited. Sole trader will decide about the scope of audit and appointment of auditor. The auditing work will depend upon the agreement of audit and the specific instructions given by the proprietor.
2. **Audit of Partnership:** To avoid any misunderstanding and doubt, partnership audits their accounts. Partnership deed on mutual agreement between the partners may provide for audit of financial statements. Auditor is appointed by the mutual consent of all the partners. Rights, duties and liabilities of auditor are defined in the mutual agreement and can be modified by the partners.
3. **Audit of Companies:** Under companies Act, audit of accounts of companies in India is compulsory. Chartered accountant who is professionally qualified is required for the audit of accounts of companies. Companies Act 1913 for the first time made it compulsory for joint stock companies to get their accounts audited from a qualified accountant. A number of amendments have been made in companies Act, 1956 and 2013 regarding appointment, duties, qualification, power and liabilities of a qualified auditor.
4. **Audit of Trusts:** The beneficiaries of the trusts may not have access and knowledge of accounts of the trust. The trustees are appointed to manage and look after the property and business of the trust. Accounts of the trust are maintained as per the conditions and terms of the trust deed. The income of the trust is distributed to the beneficiaries. There are more chances of frauds and mis-appropriation of incomes. In the trust deed as well as in the Public Trust Act which provide for compulsory audit of the accounts of the trust by a qualified auditor. The audited accounts of the trust ensure true and fair view of accounts of the trust.
5. **Audit of Accounts of Co-operative Societies:** Co-Operative societies are established under the Co-Operative Societies Act, 1912. It contains various provisions for the regulations and the working of these societies. Some of the states have adopted it without any change, while others have brought certain changes to it. The auditor of the Co-operative Society should have an expert knowledge of the particular act under which Co-operative society under audit is functioning. He should also study by-laws of the society and make sure that the amendments made from time to time in the by-laws have been duly registered in the Registrar's Office. Companies Act is not applicable to the co-operative Societies. The Registrar of co-operative societies shall audit or cause to be audited by some person authorized by him, the accounts of the society once in every financial year.

6. **Government Audit:** Audit of government offices and departments is covered under this heading. A separate department is maintained by government of India known as Accounts and Audit Department. This department is headed by the Comptroller and Auditor General of India. This department works only for the government offices and departments. This department cannot undertake audit of non-government concerns. Its working is strictly according to government rules and regulations.

Based on Time: On the basis of time the audit can be of following types:

1. **Interim Audit**: When an audit is conducted between two annual audits, such audit is known as Interim audit. It may involve complete checking of accounts for a part of the year. Sometimes it is conducted to enable the board of directors to declare an Interim dividend. It may also be for the purpose of dealing with interim figures of sales.
2. **Continuous Audit:** The Continuous Audit is conducted throughout the year or at the regular short intervals of time.

"A continuous audit involves a detailed examination of all the transactions by the auditor attending at regular intervals say weekly, fortnightly or monthly, during the whole period of trading." - T.R. Batliboi

"A continuous audit is one where the auditor or his staff is constantly engaged in checking the accounts during the whole period or where the auditor or hiss staff attends at regular or irregular intervals during the period." -R.C Williams

Advantages of continuous Audit:

a. **Complete checking of all the records:** Since the audit is carried out throughout the year, sufficient time is available for detailed checking. Any enquiry and doubt arising in the course of audit can be tackled in a better way.
b. **Proper planning:** Auditor can plan his audit work in a systematic manner. He can evenly spread his work throughout the year. It will improve efficiency of auditor.
c. **Early detection of frauds and errors:** The work of auditor becomes easier for detecting frauds and errors, otherwise it will involve more time.
d. **Up-to-date accounts:** The efficiency of account staff will increase and their work will be up-to-date and accurate.
e. **Valuable suggestions:** Continuous audit will help the auditor to understand the technicalities of business. This will help the auditor to make suggestions for the improvement of business.

f. **Preparation of interim accounts:** Interim accounts can be prepared without much delay. It will help the Board of Directors to declare interim dividend.

Disadvantages of Continuous Audit:

a. **Expensive:** It is an expensive system as it may not suit the budget of small organizations.
b. **Dislocation of routine work:** Frequent visits by auditor may dislocate the smooth flow of office work.
c. **Alteration of Figures:** after the accounts have been audited, the figures may be fraudulently altered by the staff.
d. **Losing link in the audit work:** As the work is not completed continuously, the auditor may lose continuity and certain questions and inquires may be left unanswered.

3. **Final Audit:** Final Audit means when the audit work is conducted after the close of financial year. A final audit is commonly understood to be an audit which is not commenced until after end of the financial period and is then carried on until completed.
4. **Balance Sheet Audit:** Balance Sheet Audit relates to the verification of various items of balance sheet such as assets, liabilities, reserves and surplus, provisions and profit and loss balance. The procedure under this audit is to follow a backward process. First the item is located in balance sheet, and then it is located in original record for the purpose of verification.

Based on Objectives: On the basis of objectives the audit can be of following types:

1. **Internal Audit:** It implies the audit of accounts by the staff of the business. Internal audit is an appraisal activity within an organization for the review of the accounting, financial and other operations as basis for protective and constructive service to the management. It is a type of control which functions by measuring and evaluating the effectiveness of other types of control. It deals primarily with accounting and financial matters but it may also properly deal with matters of operating nature.
2. **Cost Audit:** Cost Audit is the verification of the correctness of cost accounts and adherence to the cost accounting plans. Cost Audit is the detailed checking of costing system, techniques and accounts to verifying correctness and to ensure adherence to the objectives of cost accounting.
3. **Secretarial Audit:** Secretarial Audit is concerned with verification compliance by the company of various provisions o Companies Act and other relevant laws. Secretarial audit report includes
    a. Whether the books are maintained as per companies act, 2013.

b. Whether necessary approvals as required from central Government, Company law board or other authorities were obtained.

4. **Independent Audit:** Is conducted by the independent qualified auditor. The purpose of independent audit is to see whether financial statements give true and fair view of financial position and profits. Mainly it is for safeguarding the interest of owners, shareholders and other parties who do not have knowledge of day-to-day operations of organization.
5. **Tax Audit:** Now-a-days tax audit has become very important to ascertain the accuracy of tax related documents. Tax audit mostly covers income returns, invoices, debit and credit notes and various current and fixed assets. Tax audit is an innovation of 21st century. It has added one more chapter to the practice of auditing. Tax audit ensures the validity and credibility of tax related documents.

Unit 2

Planning of Audit and Control

Qualities of an Auditor:

The Auditor must possess the following qualifications and qualities:

1. Only the qualified chartered accountant can be appointed as auditor of a limited company.
2. The auditor must have thorough knowledge of principles and practice of all aspects of accountancy. He must be familiar with all systems of accountancy in use.
3. He should have adequate knowledge of financial management, industrial administration and business organization.
4. He must have thorough knowledge of audit case laws as per the various cases decide by the courts in and outside India.
5. He should be able to understand the technical details of business whose accounts he is going to audit.
6. An auditor must be honest i.e. He must certify that he does not believe to be true and he must take reasonable care and skill before he believes what he certifies is true.
7. He must act impartially and not influenced by others, directly or indirectly while discharging his duties.
8. He should be hard working, systematic and methodical.
9. He must have capacity to hear arguments of others.
10. He should have adequate skills and courage to write audit report correctly clearly and concisely.
11. He should not disclose the secrets of his client.

Appointment of an Auditor

Appointment of Auditor in case of Sole proprietor: The appointment of Auditor in case of sole trader is done by the owner of the business. In case of sole traders the auditor generally acts as an accountant who also prepares accounts besides checking their accuracy. As He is appointed by an individual he must get clear instructions from his client in writing as to what he is expected to do. His work and its scope will depend upon the agreement with his client since the appointment of an auditor is not under any statute, therefore the rights and the duties will depend upon the agreement.

Appointment of Auditor in case of partnership: The Auditor of a partnership firm is made by the mutual consent of all the partners

Appointment of Companies Auditors: The provisions regarding appointment of the auditor are contained in section 139 of Companies Act 2013

1. **Appointment of auditor by members [sec 139(1)]:**
    a. A company shall appoint an individual or a firm as an Auditor at the first annual general meeting and each subsequent sixth annual general meeting.
    b. Such auditors shall hold office till conclusion of sixth annual general meeting.
    c. Such appointment shall be placed before the members at each annual general meeting for ratification.
2. **Period for which the appointment is made [sec 139(2)]:**
    a. An individual can be appointed for a term no more than five years.
    b. An audit firm can be appointed for a consecutive term not more than two terms of five years.
    c. An individual or a firm which has completed its term shall not be eligible for reappointment as auditor in the same company for five years from the completion of term.
3. **Appointment of auditor of Government companies (sec 139 (5)):** The comptroller and Auditor general shall in respect of financial year appoint an auditor duly qualified within 180 days from the commencement of financial year who shall hold office till conclusion of annual general meeting.
4. **Appointment of First Auditor by Board of Directors [sec139 (6)]:** The first auditor of a company other than government company shall be appointed by the board of directors within 30 days of registration of company. If the board fails to appoint first auditor it shall inform the members of company who shall appoint auditor within 90 days at extra ordinary general meeting who shall hold the office till conclusion of first annual general meeting.
5. **Appointment of First Auditor of Government Company [sec 139 (7)]:** The first Auditor of a Government Company shall be appointed by Comptroller and Auditor general within 60 days of registration of company. In case of its failure to appoint first auditor, then board of directors shall appoint auditor within next 30 days. The company shall inform the members if

the board fails to appoint first auditor who shall appoint the auditor within 60 days at extra ordinary general meeting who shall the office till conclusion of the first general meeting.

6. Casual vacancy of an Auditor [sec 139 (8)]:

a. The casual vacancy of auditor, except in case of Government Company, shall be filled by the board of directors within 30 days but if it arises as a result of resignation of the auditor it shall be approved by company at general meeting convened within 3 months o recommendation of board. Such auditor shall hold office till conclusion of next annual general meeting.

b. Casual vacancy in case of Government Company shall be filled by Comptroller and Auditor General within 30 days if he fails to fill the vacancy, the board shall fill the vacancy within next 30 days.

Reappointment of a retiring auditor [sec 139 (9)]:

Such an auditor can be reappointed at annual general meeting if.

a. He is not disqualified for reappointment.

b. He has not given notice to company of his unwillingness.

c. A special resolution has not been passed at annual general meeting appointing some other person or providing expressly that he shall not be reappointed.

All the above is subject to the provisions of sec 139 (1)

Qualifications of an Auditor:

1. A person shall be eligible for the appointment of an auditor of a company only if he is a chartered accountant.
2. Where a firm including a limited liability partnership is appointed as an auditor of a company, only the partners who are chartered accountants shall be authorized to act and sign on behalf of firm.

Disqualifications of an Auditor:

The following persons shall not be eligible for the appointment as an auditor of a company:

1. An officer or employee of the company.
2. A person who is a partner, or who is in employment or an officer or employee of the company.
3. A person or a firm who, whether directly or indirectly has business relationship with the company, or subsidiary of such holding company or associate company of such nature as may be prescribed.
4. A person whose relative is director or is in the employment of the company as director or key managerial personnel.
5. A person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such persons or partner is at the date of such appointment or reappointment holding appointment as auditor of more than 20 companies.

6. A person who has been convicted by a court of an offence involving fraud and a period of 10 years has not elapsed from the date of such conviction.

Remuneration of an Auditor (sec 142)

1. The remuneration of the Auditor of a company shall be fixed in its general meeting or in such manner as may be determined therein.
2. The Remuneration under sub section (1) shall, in addition to the fee payable to an auditor, include the expenses, if any, incurred by the auditor in connection with the audit of the facility extended to him but does not include any remuneration paid to him by any other services rendered by him at the request of the company.

Removal, Resignation of an Auditor

1. The Auditor appointed under section 139 may be removed from his office before expiry of is term only by a special resolution of the company after obtaining the previous approval of the central Government.
2. The Auditor who resigns from the company shall file within a period of thirty from the date of resignation, a statement in a prescribed form with the company a registrar, the auditor shall also file such statement with the comptroller and auditor –general indicating the reasons and other facts as may be relevant with regard to his resignation.

Rights of an Auditor

1. **Right to Access books of accounts**: Every auditor of a company has right to free and complete access at all the times to the books, accounts and vouchers of the company
2. **Right to obtain the information and explanation**: An auditor is authorized to obtain such information and explanation as the auditor may think necessary for the performance of his duty as auditor.
3. **Right to receive notice**: All notices of the company and other communications relating to any general meeting of the company shall be forwarded to the auditor of the company. He is also authorized to attend the meetings and make any statement or explanation with regard to the accounts audited by him.
4. **Right to sign audit report**: only the person appointed as auditor of the company, where a firm so appointed only a partner in the firm practicing in India, may sign the auditor's report or authenticate any other document of the company required law to be signed or authenticated by auditor.
5. **Right to seek legal and technical advice**: The auditor of a company is entitled to seek the legal and technical advice which may be needed in the performance of his duties.
6. **Right to remuneration**: on completion of his work an auditor is entitled to his remuneration.

7. **Right to be indemnified**: for many purposes, an auditor is considered to be an officer the company. An officer has a right to be indemnified out of the assets of the company against any liability.

Duties of an Auditor: Duties under section 143 (1):

a. The auditor has a duty to enquire whether loans and advances made by the company have been properly secured whether the term and the conditions there of are prejudicial to the interest of the company or its members.
b. Duty to enquire whether assets of the company being shares or debentures and other securities have been sold at a price less than at which these were purchased.
c. Whether any shares have been allotted for cash, whether cash actually received and whether the position in the account books and balance sheet is correct, regular and not misleading.

Duties under section 143 (2):

The auditor has the duty to report the members of the company, the accounts examined by him and every financial statement to be laid before the company in the general meeting. The auditor shall state in his report to the best of his information and knowledge, the said accounts and financial statements whether give a true and fair view or not, of the state of company's affairs

Duties under section 143(3):

1. He has the duty to sought and obtain all information and explanation which are necessary for his audit.
2. He has a duty to ensure that the books of accounts as required by law have been kept by the company.
3. He has a duty to see whether the company has adequate internal financial control systems in place and their operative effectiveness.
4. He has a duty to ensure whether the company's balance sheet and profit and loss account dealt within the report or in agreement with the books of account and returns.

Liabilities of an Auditor:

The liabilities of an auditor can be summed under following heads:

1. Civil liabilities
2. Criminal Liabilities

1. Civil Liabilities:

(I) Liability for Negligence: The liability of an auditor arises where it is proved that his client has suffered a loss due to his professional negligence. The auditor may be held personally liable, if it is proved, that had he exercised reasonable care and skill, he must have discovered the discrepancy. In a case it was held that if an auditor fails to show as much skill and diligence as is expected of a man of ordinary prudence, he must suffer the consequences.

(ii) Liability for misfeasance: According to section (340), the court may assess damages against delinquent director and other officers of the company, including an auditor for misfeasance or breach of trust. In case of an auditor who also comes within the definition of officer in section 2 (59) for purpose of the section, if he is guilty of neglect of duty or misfeasance, so as to cause loss of company in any way, proceedings may be taken under this section against him either independently or other officers or jointly with them. This section provides a simple way to the company to recover damages where an auditor or any other officer of the company is guilty of misfeasance. The time limit for bringing an action is 5 years.

2. Criminal Liabilities:

i) Mis-statement in prospectus section 34: Where an auditor makes false statement with material particulars in returns, reports, prospectus or other statements knowingly it to be false or omits any material facts knowing them to be false, he shall be punishable with imprisonment for a minimum term of 6 months extendable to 10 years.

ii) Non compliance by auditor with section 143 and 145: If the auditor does not comply with section 143 and 145 regarding making his report or signing or authentication of any document and makes willful neglect on his part he shall be punishable with imprisonment up to 1 year and with fine not less than twenty thousand extendable to five lakhs.

In case an auditor knowingly or willfully with the intension to deceive the company or shareholders or creditors or tax authorities, he shall be punishable with imprisonment up to 1 year and fine not less than 1 lakh extendable up to twenty five lakhs.

iii) Failure to assist in the investigation section 217 (6): Where the central Government appoints an inspector to investigate the affairs of the company, it is the duty of the auditor to preserve and produce to the inspector all books and papers relating to the company. If an auditor fails to assist the inspector in investigation he shall be punishable with imprisonment up to 1 year and with fine not less than twenty five thousand extendable to 1 lakh

iv) Penalty for falsification of books section 336: Any officer including auditor of a company which is being wound up, with an intention to defraud or deceive any person, destroys, mutilates, alters, falsifies any books, papers or securities. He shall be punishable with imprisonment for

a term not less than 3 years extendable to 5 years and with fine not less than 1 lakh extendable to three lakhs.

V) Penalty for deliberate act of commission or omission section 448: If any officer including auditor of the company deliberately make a statement in any return, report, certificate, balance sheet, prospectus etc. which false or which contains omission of material facts he shall be punishable with imprisonment for a term not less than 6 months extendable to 10 years and fine not less than amount involved in fraud extendable to 3 times of such amount.

Audit Programme

Meaning and Definition

Audit programme represents an outline of procedure to be followed to support an opinion on financial statements. It is the auditor's plan of action. It provides a plan of work of examination and a set of audit procedures.

According to Megis, An audit programme is a detailed plan of the auditing work to be performed, specifying the procedure to be followed in verification of each item in the financial statements and giving the estimated time required.

According to holmes, Audit programme is a flexible planned procedure of examination. Thus audit programme is a planning of audit by auditor so that he may be able to complete his work in a diligent manner and complete the work without loss of time.

Advantages of audit programme:

Some of the important advantages of thee audit programme are:

1. It enables the auditor to keep in touch with the work done and general progress of the work.
2. The auditor can be certain that the audit staff will cover whole of the ground.
3. It will help the audit assistants to know their duties.
4. It helps to increase the efficiency of audit assistants.
5. Fixing of the responsibility of audit assistants becomes easier.
6. It provides a check against the possibility of certain important items requiring verification which are being omitted.
7. Continuity is not lost even if the person on the duty is changed.

Audit Note book:

Audit note book is a diary or register maintained by audit staff to note errors, doubtful quarries and difficulties. The purpose is to note down the various points which need to be either

Clarified with the client or the chief editor. The Audit note book is used for recording important points to be included in the auditor's report.

Contents of an Auditor's Note Book:

1. A list of books of accounts maintained.
2. The names, duties and responsibilities of principal officers.
3. The particulars of missing receipts and vouchers.
4. Mistakes and errors detected.
5. The points which need clarifications and explanations.
6. The points deserving the attention of the auditor.
7. Various totals and balances.
8. The Points to be a part of auditor's report.

Advantages of Audit Note book:

Some of the advantages of the audit note book are.

1. It ensures the uniformity and helps in knowing the amount of work performed.
2. Important matters relating to the audit work may be easily recalled.
3. Facilities and preparation of the audit report.
4. In case of the assistant in charge is changed, no difficulty is faced in continuing the incomplete work.
5. The responsibility of the errors undetected can be fixed on clerk concerned.
6. The audit note book shows the extent of the interest and pain taken by the audit staff. It helps in their appraisal.
7. It ensures that the audit programme has been sincerely followed. Deviations can be noticed.
8. It is reliable evidence in the court of law, If an auditor has to defend himself.

Audit working papers

Meaning and Definition

The term audit working papers designate the files of analysis, summaries, comments and correspondence built by an auditor during the course of the field work of an audit engagement. These papers contain essential facts about the accounts which are under audit.

According to Arnold W. Johnson, '' Audit working papers are the written private materials, which an auditor prepares for each audit. They describe the accounting information which he receives from his client, the methods of examination used, the conclusions (and reasons thereof) and the financial statements."

According to Jack C. Robertson, "Working papers are auditor's own evidence of compliance with generally accepted auditing standards and of the decisions respecting all procedures necessary in the circumstances unique to the audit engagement."

They consist of draft copies of trial balances, adjusting entries, accounts analysis, schedules of debtors and creditors summaries of reconciliation statements, certificates of official comments, copies of correspondence between auditors and debtors, creditors and bank, detailed schedule of items like depreciation, inventories previous audit reports, important quarries with explanation audit programme and other important materials.

Objectives of Audit working papers

The working paper serves following purposes:

1. They represent the volume of work performed by the auditor and his staff, which helps in preparing the report.
2. They show the extent of adherence to accounting principles and auditing standards.
3. They are useful as evidence against the charge of negligence.
4. They act as guide for subsequent examinations.
5. They enable the auditor to know the weakness of the internal check system in operation as also the accounting system.
6. They assist the auditor in coordinating and organizing the work of audit clerks.
7. They assist in planning and performance of audit work.

Internal Control

Meaning and Definition

Internal control is a broad term with a wide coverage. It covers the control of whole management system. Internal control involves a number of checks and controls exercised in a business to ensure its efficient and economic working.

According to The American Institute of Certified Public Accountants, "Internal control comprises of the plan of organization and all the coordinate methods and measures adopted within a business to safeguard its assets, check the accuracy and reliability of its accounting data to promote operational efficiency and to encourage adherence to prescribed managerial Policies."

The system of internal control can be defined as, "the plan of organization and all the methods and procedures adopted by the management of an entity to assist in achieving the management's objectives of ensuring, as far as practicable, the orderly and efficient conduct of its business."

In brief it can be stated that internal control includes not only internal check and internal audit but the whole system of controls, financial and otherwise, established by the management in order to carry on the business of the company in an orderly manner, to safeguard its assets and to secure as far as possible the accuracy and reliability of records.

Objectives/Need of the Internal Control:

1. Providing reliable data: Business decisions require accurate information o run the business efficiently. Examples of significant areas where management requires reliable information are fixation of selling prices production directives depending upon requirements etc. with the efficient internal control in place the accurate, required and reliable information can be provided for taking the important decisions and efficient performance of the activities.
2. To promote operational Efficiency: the controls within an organization are meant to prevent unnecessary duplication of efforts, protect against waste in all aspects of business and discourage other types of inefficient use of resources so as to promote the operational efficiency.
3. To encourage adherence to the prescribed policies: the system of internal control is meant to provide reasonable assurance that procedures and rules of various institutes are followed by company personnel.
4. Safeguarding assets and records: the physical assets of the company can be stolen, misused or accidently destroyed if not properly protected by adequate controls. The internal control helps to safeguard the physical assets and to secure the accuracy and reliabilities of the records of the company.

Internal Check

Meaning and Definition:

Internal check is the valuable part of the internal control. It is an arrangement of the duties of members of staff in such a manner that the work performed one person is automatically and independently checked by the other.

According to F.R. M.e paula, “internal check means practically a continuous internal audit Carried on by the staff itself, by means of which the work of each individual is independently checked by other members of the staff.”

According to D.R. Davar, “ Internal check is a system or method introduced with defined instructions given to staff as to their sphere of work with a view to control and the verification of their work and also the maintenance of accurate records as the ultimate aim.

According To Joseph Lancaster, “The internal check is a method of organizing the entire operations, office, warehouse, factory and the duties to the respective staff so that frauds and irregularities are impossible without collusion.”

All the definitions of internal check give a common idea about system organized within the concern itself, wherein the work of one employee is automatically checked up by the other and the possibility of error or fraud is reduced to the minimum.

Objectives of internal check:

1. To exercise moral pressure over the staff.
2. To ensure that the accounting system produces reliable and adequate information.
3. To provide protection to the resources of the business against fraud, carelessness and in efficiency.
4. To distribute work in such a manner that no business is left unrecorded.
5. To allocate duties and responsibilities of each clerk in such a way that he may held responsible for particular fraud or error.
6. To increase the efficiency of clerks because the allocation of duties is based on the principle of division of labour.
7. To detect errors and frauds easily if it is committed, because in an efficient internal check system, there is a provision for independent checking.

Advantages of Internal Check:

1. Proper division of work: internal check entails a proper and rational distribution of work among the members of staff of the enterprise keeping in view their individual qualifications, experience and area of specialization.
2. Detection of errors and frauds: since no individual worker is allowed to handle a job completely from the beginning to the end, and the work of each clerk is automatically checked by the other, this helps in the early detection and discovery of errors and frauds.
3. Increased efficiency coupled with economy: A good system of internal check increases the efficiency of work among the staff and leads to overall economy.
4. Convenience to auditor: where an organization is operating the system of internal check, the statutory auditor may conveniently avoid detailed checking of the transactions. He may apply a few tests here and there and can relieve himself from detailed checking.
5. Accuracy of the accounts can be relied upon: If there is a good system of internal check the owner of the concern may rely upon the genuineness and accuracy of the accounts.
6. Increase in Profits: overall efficiency and economy in operations result in more profits- thus ensuring larger dividends for the owners or shareholders.

Internal Check With Regard To Sales:

The system of internal check regarding sales should take care of following0:

1. On receipt of the order, it should numbered and preserved in Orders Received Book with full particulars.
2. The Despatch Department should be given a copy of the order with necessary particulars.
3. The Despatch Department should take steps to pack the goods as per order.
4. The statement of goods as prepared by the Despatch Department should be checked with the customer's order and then invoice will be prepared in triplicate by means of carbon papers.
5. A responsible official should check the invoice particularly the rates charged and calculations made.
6. With the help of the copy of invoices entries should be made in Sales Day Book.
7. On dispatch of the goods records should be made in the Goods Outward Book.
8. Two copies of the invoice may be sent to customer who will return one of them after signing it. It will serve the purpose of delivery note. Third copy will be retained for further reference.
9. Entries should be made in Goods inward Book for all the goods returned by the customers. Credit notes should be prepared and should be duly checked and initialed by the responsible official.
10. With the help of credit notes, records should be made in the Sales Return Book.

Internal Check With Regard To Purchases:

1. Requisition: the procedure for issuing purchase requisitions should be specified. The head of the department, who is need of goods, should fill a requisition slip duly signed and then should send to the purchase department. The details about the quality, quantity and the time by which the goods must be supplied be clearly mentioned in the requisition slip.

2. Enquiry: Purchases department makes an enquiry about terms and conditions of the purchases from different suppliers for these purposes tenders are generally invited. But, who shall open and accept the tenders, should be clearly specified. As rule lowest tender should be accepted and decision be taken.

3. Purchase Order: the purchase department places orders which should be recorded in the purchase order book. Four copies of purchase order should be prepared. One copy will be sent to vendor, the second to the store department, third to the accounting department and fourth will be retained by the purchase department itself. A responsible officer should review the purchase order, before signing by the authorized person or director.

4. Receipt of goods: on receipt of goods, the purchase department should properly inspect them, and after an entry in the goods inward (receipt) book, the same should be sent to the stores. Concerned department should be informed about the receipt of goods.

5. Making the payments: the purchase department should thoroughly check the invoices and send the same to accounting department for payment. The accounting department should compare the invoice with the purchase order and incoming inspection report and

should verify the calculations. The accounts department should enter the invoice in purchase book. Only responsible official should draw cheque for the payment of invoice. At the time of signing, a signing authority must verify that correct payment is made.

Internal check with regard to fixed assets:

1. A proper authority should be designated for the sanction of capital expenditure. The authority may be given to managing director, a factory manager or a committee may be set up for this purpose.
2. A proper authority should be designated even for sale of fixed assets, transfer or even for discarding of an asset.
3. Proper accounting records in respect of fixed assets should be maintained and it should be ensured that the proper accounting distinction is observed between capital and review expenditure.
4. There should be a periodic inspection of assets.
5. A fixed asset register must be maintained giving details of all the fixed assets. In this register description of the assets, their cost and location should be mentioned. Management should also ensure that all the fixed assets are verified physically from time to time.
6. Perfect arrangements should be made to ensure that fixed assets are properly maintained and applied in the service of the company.
7. Where the fixed assets are transferred between branches or members of the sale group, proper arrangements in respect of their pricing, depreciation and accounting should be made.
8. Depreciation rates are to be authorized and evidenced and which persons are to be responsible for carrying out and checking the necessary calculations.
9. Lastly it should be seen that these fixed assets should be adequately insured.

Internal check with regard to cash transactions

CASH RECEIPTS:

1. There should be a separate clerk known as cashier to deal with the receipts of cash. Immediately upon receipts of cash a rough record of the amount should be made. The cashier should not be authorized to keep cash with him. He should not be allowed to make expenditure out of it and to make entries in the ledger an d other books of prime entry.
2. All receipts should be banked daily. From time to time the bank reconciliation statements should be prepared to reconcile bank and cash balances.
3. Bank pay- in-slips should not be prepared by the same person who is incharge of making actual deposits in the bank.

4. All receipts should be acknowledged by means of printed receipts. Counter-foils of all the receipts issued should be properly maintained. Unused receipt must be kept with some responsible officer.
5. Spoiled receipts should be cancelled and not torn off. If some alterations is made in the receipts already written, it should be properly initialed.
6. Copies of receipts previously issued must be marked duplicate.
7. Some responsible persons of the firm should verify the balance of cash by carrying out a surprise physical check from time to time.

CASH PAYMENTS:

1. The person in charge of making payments should have no connection with the receipts of cash.
2. All payments should, as far as possible be by chance cheques excluding petty cash payments. The cheques drawn for payment should be order cheques and as far as practicable they should be crossed.
3. Arrangements should be made to ensure that the vouchers supporting payments cannot be presented for the payments twice, such vouchers should be stamped as paid before the cheques are signed.
4. An official should check up the statements received from creditors and verify with the invoices and ledger accounts only after proper verifications cheques should be drawn in favour of the creditors.
5. For sanctioning the payments of special nature, only directors and senior officers should be empowered.
6. Bank reconciliation statements should be prepared to reconcile bank and cash balances from time to time by some authorities other than the cashier.
7. Bank cheques must be held under lock and key with a responsible officer.
8. Receipts duly signed and stamped should be obtained for each payment.
9. Receipts so obtained should be properly arranged and maintained through proper filing system.
10. To ensure the availability of cash discounts, monthly or periodic payments should be made on the fixed dates.

Unit 3

Vouching and Audit of Financial Statements

Vouching

Meaning and Definition

Vouching is concerned with examining documentary evidence to ascertain the authenticity of entries in the books of accounts. In other words it is an inspection by the auditor of evidence supporting the transactions made in the books. Vouching is a technique used by an auditor to judge the truth of entries appearing in the books of accounts. Some important definitions of vouching are:

"Vouching means testing the truth of items appearing in the books of original entry." – J.R. Batliboi

"Vouching is an act of comparing entries in the books of accounts with documentary evidence in support thereof." - Dicksee

From the above definitions we can conclude that vouching is a technique in which an auditor verifies authenticity and authority of transactions recorded in the books and on the basis of which he submits a report, indicating that accounts are correct, free from errors or fraud and complete.

Objectives of Vouching:

1. All the transactions which are connected with the business have been recorded in the books of accounts properly.
2. To verify that all transactions recorded in the books of accounts are supported by documentary evidence.
3. The vouchers which support the entries are legally valid from the view point that they are authentic, addressed to the business and properly dated.
4. To verify that no fraud or error has been committed while recording the transaction in books of accounts.
5. The vouchers have been processed carefully through various stages of internal check system.
6. While recording the transaction whether distinction has been made between capital and revenue items.
7. Whether accuracy has been observed while totaling, carrying forward and recording an amount in the account.

Vouching of cash Transactions:

How to vouch various cash receipts (Receipt side)

1. **Cash sales**: In vouching cash sales, cash register should be fully checked with carbon copies of cash memos. Then, the auditor should verify the daily deposits of cash received in the bank dates of the cash and the date on which the receipts are recorded in cash book must be same. Where the cash memos are cancelled, all copies including the original copy duly cancelled should be kept in the book. Where a company has a discount policy, if more discount is allowed in a transaction it must be approved by a responsible officer.
2. **Cash received from the debtors**: The auditor should verify amount received from debtors from the counterfoils or carbon copies of the receipt issued to the customers. All these receipts should be serially numbered. Amount should be entered in the cash book on the day when received. Discount allowed to customers should be authorized by a responsible officer. Sometimes correspondence made with customer can also be verified.
3. **Loans:** While vouching the loans received, the terms and the conditions contained in the agreement should be verified. If the loan is secured what security has been offered, whether the fact has been disclosed in the balance sheet.
4. **Bills receivable:** Bills receivable book maybe verified because the various details regarding the bills matured and discounted are available in it. Auditor should check the amount received with the bank statement. Some bills might have become due but no amount has been received. Whether the entry for the dishonor of such bill has been made.

   A verification of the bills discounted should be made**.** Whether, entry for discount has been made. Such bills should appear as contingent liability in the balance sheet; if the date of maturity is after the date of balance sheet.

5. **Sale of Investment:** If the sales have been affected through a bank, the auditor should examine the bank advice to know the various details. Sometimes the investment is sold through the broker. Broker's sold note or commission should be examined to verify the sale proceeds and commission charged by the broker.

   If the investments are sold at cum-dividend price, auditor should see that proper apportionment has been made between capital receipts and revenue receipts.

   Sometimes the investments are made against specified funds. Profit or loss on sale of such investments must be transferred to such funds account.
6. **Sale of Fixed Assets:** Sale of fixed assets may be vouched with minute book of board of directors, correspondence, agents' sale account and sale contract. It should be seen that proper account has been credited. Any profit arising on the sale of asset shall be credited to revenue account which is not available for distribution of dividends. If any expense on the sale of assets is paid, the sale proceeds of the asset should be reduced by such amount and the balance should be credited to asset account. It must be seen that sale of fixed assets has been sanctioned by the authorized person or committee.

Vouching of cash payments (payment side):

1. **Cash Purchases:** good purchased are actually received by store keeper. Cash memos can be compared with goods inward book to verify the goods received. Only the net amount (after trade discount) should be entered in the books.
2. **Payment to creditors:** Should be examined with the receipts issued by the creditors. The receipts should indicate the purpose for which the payment has been made. If the payment is made in full and final settlement of account, the balance should be accounted for as discount received. Where the payment is made in excess of the bill, either the excess payment is in advance or the payment is made by mistake, which should be recovered back from the creditor.
3. **Bills payable:** Bills payable honored on the date of maturity and is returned by the payee after receiving the payment. These bills should be cancelled after being paid. Bills payable paid can be vouched with bills book. If the payment is made by the bank, bank statement or pass book can be examined to verify the payment of bill
4. **Wages:** wages paid and calculated for various months should be compared. If the wages of particular month differ from the preceding month, the auditor should look into the reasons for difference. Random checking of wages calculations should be made. The auditor should see the proper record is maintained for unpaid wages, deductions for any advance taken by the worker should also be verified, and deductions made from the wages should also be entered in the proper account. Special attention should be given to the payments made to casual workers.
5. **Payment Of Salaries:** in vouching the payment of salaries following points are important
    a. Auditor should check salary register with the entries made in the cash book
    b. He should examine carefully alterations in the amount of deductions on account of fines, funds, loans, insurance etc.
6. **Purchase of Investment:** the auditor should compare the investment purchased with Broker's Bought Note. If the possible, physical verification of investments should be made. Investments must be in the name of the company. Where the investments are purchased at cum-interested price, interest included in the purchase price should be debited in the interest account and the balance in investment account. Later on when the interest is received on the investment, it should be credited in the interest account.
7. **Rent paid:** the auditor should verify the payment of rent from the agreement. The ret voucher should be supported by rent receipt from the landlord. It should be seen that payment of rent is sanctioned by responsible officer.
8. **Loans:** Auditor should be that the loan voucher should be supported by the receipt given by the party**.** Further details regarding terms and condition of the loan can be verified from the loan agreement. It should be seen that installment of loan along with interest are received in time. Mortgage Deeds and other documents should also be examined.
9. **Interest on Loan:** Auditor should verify that rate of interest on loan does not differ from the terms and conditions of loan agreement. Debenture interest can be verified from

debenture interest book. All the payments of interest must be supported by vouchers and receipts.

Vouching of Trading Transactions

Vouching of purchase book:

The main aim vouching of purchases book is to see that all purchase invoices are entered in purchases book and the goods entered in the purchases book are entered are actually received by the business.

While vouching credit purchases the auditor should examine and see the following points.

i. There should be proper record for all purchase orders. A duplicate copy of the order is kept in office for record.
ii. A copy of purchase order shall be send to the Accounts Department.
iii. All goods received should be recorded on goods received note; a copy of it should be sent to Accounts Department.

1. The auditor should see that only credit purchases of the goods are recorded in purchase book.
2. The purchases book can be verified from purchase invoices, copies of orders placed, goods received note, goods inward book, copies of challans from suppliers.
3. The quantity mentioned in the invoice must be same as is shown in the purchase order.
4. The price charged by the supplier must be as per quotation/pricelist of the supplier.
5. The supplier bill must be in the name of business and for the period under audit.
6. While vouching the purchase vouchers, each voucher should be stamped or initialed after examination, so that it could not be produced again.
7. Any purchase, made not for the purpose of business of the client, must not be debited to purchase account.
8. Duplicate invoices must not be entered in the purchase book if original invoices have already been recorded.
9. The auditor should be more careful while vouching the purchase made in th first and last month of the accounting period, because sometimes the purchase of last year may be included in the purchases of first month of current year or purchases of the last month of current year may be recorded in the next.

Vouching of Purchase Returns

While vouching the purchase returns the following points should be taken into consideration by the auditor.

1. He should see that a Debit note has been sent to the supplier or Credit note has been received from the supplier.
2. The quantity returned as per the return note must correspond with storekeeper's record, return outward register and gatekeeper's outward register.
3. The amount showed in the credit note should be verified.
4. He should be careful about the recordings of purchases return in the current year. Sometimes the profits of current year may be manipulated by recording current year's purchases return in the subsequent year.
5. The purchases return of the first month and last month of the Accounting year should be vouched carefully, to detect any manipulation of amounts.

Vouching of Credit Sales

1. The sales register should be examined with copies of sales invoices. The sale of capital items should not be recorded in the sales book, otherwise the profits will be inflated.
2. Test check should be applied on the calculations made in sale invoices.
3. The totaling and the castings of sales book should be verified.
4. Sales Tax, duties collected thorough sales invoices must be recorded under separate accounts.
5. It should be verified that all sales invoices are prepared on the basis of challans and then sales invoices are entered in sales book and from there, posted to their respected accounts.
6. Sales made in the current year must be recorded under that year and shall not be treated as sales of subsequent year.
7. All cancelled sales invoices must be kept together for verification by auditor, Who should see that cancelled invoices are properly treated in the books.
8. The statement of accounts should be verified by getting confirmations from the customers.

Vouching of Sales Return

The Auditor should pay special attention to the following while vouching the sales return

1. Date on which the goods are actually retuned.
2. Credit note or Debit note of sales return.
3. Gatekeeper's receipt book.
4. Return inward register.
5. Stores records.
6. Corresponding entry for the return of goods in customer's account.
7. Goods returned should form the part of closing stock at cost price or market price whichever is less.

Vouching of Goods sent on consignment basis

The goods sent on consignment basis by principal to his agent should not be considered as sale. Only when the goods are sold by the consignee, the entry for sale should be made in the books. The goods sent on consignment still lying with the consignee should be taken into closing stock. A separate book should be maintained to show the record of goods sent on consignment basis. At the end of the year an account sale is received by the consignee, indicating the goods sold by him and balance of closing stock of goods sent on consignment basis. The auditor should verify the goods sent on the consignment basis from proforma invoices, goods outward register, correspondence with consignee and account sales.

Investigation

Meaning and Definition

Investigation involves inquiry into facts behind the books and accounts into the technical, financial and economic position of the business. Investigation is a critical examination of the books and accounts with a specific objective.

"The term investigation implies an examination of the accounts of a business for some special purpose." - Spicer and Pegler

"An investigation is an examination of accounting records undertaken for a special purpose; in fact, it is an audit of which the scope the scope is limited or extended in accordance with requirements of the particular purpose. Its object is usually to discover and display the facts in such a manner as will enable the parties for whom it is undertaken to draw conclusions and make their decisions accordingly."

Features Of investigation

1. It is critical examination and is based on Suspicion on the state of affairs to be investigated.
2. It may even extend to the examining of individuals like Directors, Auditors and other officers of the company
3. It does not confine itself only with the financial aspects but technical, political, economical and managerial aspect are also accounted for.
4. The investigation is normally conducted with certain specific objectives.
5. With the predefined objectives, the scope and the nature of investigation may be limited or extended.
6. The investigator submits his report of investigation only to his client, who appoints him.
7. In the investigation report, the factual information is given in an analytical and descriptive manner.
8. No specific rules and provisions are framed for the investigation. Investigation is voluntary and contractual in nature, except in companies.

9. It suggests the outlines for the future course of action on a particular problem.

Difference between Investigation and Audit

1. An Audit is carried out to ensure that the balance Sheet and the profit and Loss A/C show a true and fair picture. But, on the other hand, an investigation is carried out on for some predefined purpose e.g. to know the financial position of the company or its earning capacity.
2. An Audit is limited only for an examination of the accounts of the concern but the investigation covers not only examination of accounts, it involves probing deep into the matter and looking for required information far behind the books whenever necessary.
3. The Investigation is not legally compulsory but audit is statutorily compulsory in case of joint stock companies.
4. Auditing can only be conducted by a chartered accountant but it is not necessary that an investigator must be a Chartered accountant.
5. An audit is always carried out on behalf of the owner of the business, but the investigation may be conducted on behalf of the proprietor of the business, in case he suspects any fraud, or on behalf of the outside parties.
6. An audit always relates to a period of 1 year or 6 months but the investigation may cover several years.
7. Investigation is done when the books of accounts are already subject to a regular audit i.e. the investigation starts where the audit ends.
8. Unlike auditor, an investigator is not bound by accounting conventions, policies and disclosure requirements.

Verification

Meaning and Definition

Verification means the procedures normally carried out at the year end, to confirm the ownership, valuation and existence of items at the balance sheet date. In simple words verification means, 'proving the truth or conformation.'

"The verification of assets implies an enquiry into the value, ownership and title, existence and possession, and the presence of any charge on the assets." - **Spicer and Pegler**

Valuation

Meaning and Definition

Valuation means to set the exact value of an asset on the basis of its utility. Valuation forms an important part of the everyday audit. It is because the accuracy of balance sheet depends much upon how correctly the estimation of the value of various assets and liabilities has been made. Both over-

valuation and under- valuation of assets and liabilities would exhibit wrong picture of the financial affairs of a concern. The auditor has to see that the assets and liabilities appearing in balance sheet have been exhibiting their proper value i.e. neither they have been over-valued nor under- valued.

Methods of Valuation:

1. **Cost price**: The price which is paid for the acquisition of an asset is known as cost price, of course the expenses incurred in the purchase of an asset and its installation in its cost price.
2. **Market value**: A value which an asset can fetch in the market when sold is known or termed as Market value.
3. **Replacement Value**: It is a price at which a particular asset can be replaced. The assets such as commission, freight etc. is included in such a value.
4. **Book Value**: A value at which an asset appears in the books of accounts is known as its book value. It is usually the cost less depreciation written off so far.
5. **Going Concern value or Conventional value or token value or Historical value**: It is equivalent to the cost less reasonable amount of depreciation written off. No notice is taken of any fluctuation in the price of the assets. Reason for this is that these assets are acquired for use in the business and not for sale.
6. **Residual Value:** A value which will be realized in the market and received from the sale of an asset it is known as its realizable Value.
7. **Scrap Value:** A value which is obtained from the asset if it is sold as scrap.

Verification and Valuation of Different assets

For the purpose of convenience we may divide the assets in the following categories

1. Intangible Assets. Viz., goodwill, patents, trademarks, copyrights etc.
2. Fixed Assets viz., land and building, plant and machinery, furniture and fixtures etc.
3. Floating assets viz., cash in hand and at bank, BR, stock in trade, sundry letters etc.

Intangible assets:

1. Goodwill:

Verification: Where goodwill has been purchased along with a running business, the same should be verified from the agreement with the vendor showing the price paid for it. But when the amount is not specially fixed, the goodwill is the amount for the purchase of the business over the net assets taken over.

It should be verified that the goodwill has been recorded in the books of accounts only when some consideration in money or its equal has been paid for.

In case of partnership the auditor should verify the changes made in the goodwill account from time to time on the basis of provisions made I the partnership deed.

Valuation: Goodwill should be valued at a cost less amounts written off.

2. Patents:

Verification: The Auditor should examine the patents with the help of certificate which have granted such patent rights. The auditor should also ensure that the patents are registered in the name of client

Valuation: patents must be valued at cost less depreciation. The patents should be written off in a period of sixteen years after which the right automatically lapses unless the term is extended.

3. Copyrights:

Verification: In verifying the copyrights, auditor should inspect the agreement between the auditor and the publisher.

Valuation: Generally the value of the copyright is not stable because copyrights lose their value by passage of time. In the balance sheet copyright must be shown a cost less amounts written off from time to time.

4. Trademarks:

Verification: Trademarks can be verified by examining the assignment deed duly endorsed by the office of the registrar of trademarks. In case they have been purchased from others, the auditor should vouch the expenditures incurred in connection with their acquisition e.g. registration fees, payments made to designers etc.

Valuation: The valuation method is the most suitable method valuation of trademarks. it should be seen that trademarks are properly valued and shown in balance sheet.

Fixed Asset:

1. Freehold land and building:

Verification: The auditor should examine the title deeds to ensure that they are in the name of the client. Any addition or sale during the year should be carefully examined.

Valuation: Freehold land being a no depreciable asset is generally shown at cost which includes the purchase price, broker's commission, registration fees, legal charges etc. Any payments made to Municipality Corporation or improvement trust as developmental charges should be included in the cost. If market realizable value is taken as basis for valuation of freehold land the same should be disclosed clearly in the balance sheet

Valuation of buildings: Buildings should always be valued at cost less depreciation at a reasonable rate. Actually, the market or realized value of the buildings

keeps on fluctuating. Therefore, it should be taken into account while valuing the buildings.

2. Leasehold property:

Verification: The auditor should inspect the lease agreement to find out the value and duration. The auditor should see that lease agreement is registered with the registrar and certificate testing to the validity of the same.

Valuation: Leasehold land and buildings are to be valued at cost less depreciation which should be sufficient writes it off completely during the period of lease

3. Plant and machinery:

Verification: Auditor should commence the process of verification by obtaining a schedule of plant and machinery certified by responsible officer of the concern.

Valuation: For valuing the plant and machinery, the auditor should prepare a list of each machine from the plant register and should get the list certified by the woks manager. The auditor should see the plant and machinery account is shown in the balance sheet at cost less depreciation after making proper adjustments regarding new purchases of machinery and sale of older machinery during the year.

Floating Assets:

1. Cash in hand:

Verification: The auditor should verify the cash in hand by actually counting it on the date of balance sheet.

2. Cash at Bank:

Verification: The auditor should verify cash at bank by comparing the balance shown in cash book and pass book. In verifying the bank balance the auditor should also prepare bank reconciliation statement to ascertain the correct position**.**

3. Stock in trade:

Verification: It is practically impossible for auditor to physically verify each item of the stock in hand because of various reasons i.e. limited time and the lack of technical knowledge. Therefore the auditor has to rely upon test checks to ascertain the accuracy of stock in trade

Valuation: The stock in trade being a floating asset should be valued at cost price or market price whichever is less.

The cost price can be calculated from any of the following methods

a. Unit cost method
b. Average cost method

c. First in first out method (FIFO)
d. Last in first out method (LIFO)
e. Highest In first out (HIFO)
f. Base stock method
g. Adjusted selling price method
h. Standard cost method.

4. Investments:

VERIFICATION: The auditor should verify the details of the schedule of investment by applying tests e.g. financial journals and newspapers should be consulted for checking the market rates. The securities themselves may be consulted or the broker's notes may be examined for checking the cost etc.

The auditor should verify the amount of interest or dividends ass have already have been declared before the date of the balance sheet, should be taken into account as outstanding ones.

Valuation: If investments are to be held as a fixed asset for the purpose of earning interest/dividend; these are to be valued at cost which includes brokerage and stamp duty paid in regard there to.

But if the investments are held as current assets, these assets should be valued at cost or market price whichever is less. The auditor may come across the situations where the market Value is much below the cost of acquisition of investments. Ordinarily he should ignore a temporarily fall in the market value, but where the fall in value seems to be of a permanent nature, he should see that adequate depreciation is provided by passing the required entries.

Verification of Liabilities:

Capital:

In case of firm, the auditor should verify the liability on account of the capital with the help of partnership deed; pass book and the cash book.

In case of a company auditor should examine the memorandum of association to verify the information as to the maximum capital the company is authorized to raise. He should also ascertain the amount of called up in respect of each class of shares and also ascertain how many shares of each class are allotted as fully paid. Auditor should also specify the sources from which the bonus shares are issued i.e. capitalization of profits are reserves for share premium accounts. He should also ensure that capital profit, if any on issue of forfeited shares, has been transported to capital reserve.

Debenture:

The auditor should note the following points while verifying the depreciation:

a. Debenture trust deed' should be inspected and with its help, the debenture account in the ledger should be examined.
b. If necessary, the auditor can obtain a certificate from the debenture holders.
c. Since the debentures are supposed to be redeemed, the auditor should see the arrangements for their redemption.
d. The debenture may be issued at par or at premium.
e. The auditor should see the details as given in the Register of Mortgages and charges.

Trade creditors:

a. The First task the auditor is to ask for schedule of creditors.
b. The purchase ledger should be checked with the books of original entry, invoices and credit notes etc.
c. Discount on creditors should be checked with reference to creditor's account.
d. If any debt Is found unpaid for a longer period of time any enquiry should be made since it is possible that instead of paying to the creditor the amount might have been misappropriated

Loans:

The auditor should examine the loan agreement in order to ascertain the terms of loan, amount of loan and period and the nature of the loan. In case the loans are overdrafts have been taken from a bank an agreement with the bank and a certificate to that effect should be obtained and examined**.**

Outstanding liabilities for expenses:

The auditor should obtain a certificate from responsible officer of the company stating that all outstanding liabilities for expenses incurred have been brought into account.

The auditor can verify those items of expenses which usually constitute outstanding liabilities. E.g. salaries payable, legal expenses, rent, wages, audit fees etc.

Reserves and Funds:

The auditor should examine and verify that whether the decision to create reserve or fund is dictated by needs and circumstances of business and relevant legal provisions and check the relevant entries in books of accounts and check the entries passed for the purpose in the profit and loss appropriation account.

Income Received in Advance

The auditor should examine the schedules of income received in advance and ensure that these are fully disclosed in the balance sheet

The auditor duty is to examine whether interest, rent, installments etc, received in advance should be classified as liability and shown as such in the balance sheet.

Distinction between vouching, verification and valuation

	Vouching	Verification	Valuation
Meaning	**Vouching is a process of comparing the entries in the books of accounts with the bonafide vouchers**	**Verification is a process which proves the existence, ownershipand title to the assets**	**Valuation is a process which certifies the correct value of the assets and liabilities at the date of balance sheet.**
Subject matter	**Vouching is made of the entries recorded in the books of original entry and their posting in the ledger**	**Verification on the other hand is made of assets and liabilities appearing in the balance sheet at the end of the year**	**Valuation is also made of assets and liabilities appearing in the balance sheet at the end of the year**
By Whom	**Vouching is done by the senior auditor and audit clerks.**	**Verification on the other hand is done by the auditor himself or his associates**	**Valuation on the other hand is done by the auditor himself or his associates**
When	**Vouching is done after the entry of transactions in the account books**	**Verification on the other is done at the end of the financial year when the final accounts are to be prepared**	**Valuation on the other is done at the end of the financial year when the final accounts are to be prepared**
Evidence	**In vouching , bonafide vouchers are sufficient evidence for vouching**	**Verification is made on the basis of evidence such as the title deeds, receipts and payments etc.**	**In valuation an auditor has to depend upon the certificates of the owners/directors.**

Audit of Financial Statements

Audit of Financial statements is the examination of an entity's financial statements and accompanying disclosures by an independent auditor. The result of this examination is a report by the auditor,attesting to the fairness of presentation of the financial statements and related disclosures. The auditor's report must accompany the financial statements when they are issued to the intended recipients. The purpose of a financial statement audit is to add credibility to the reported financial position and performance of a business.

Audits have become increasingly common as the complexity of the two primary accounting frameworks, Generally Accepted Accounting Principles and International Financial Reporting Standards, have increased, and because there have been an ongoing series of disclosures of fraudulent reporting by major companies.

Auditor's duty with regard to:

Fixed Assets:

1. **Freehold land and building:**

   The auditor should examine the title deeds to ensure that they are in the name of the client. Any addition or sale during the year should be carefully examined.

2. **Leasehold property:**

   The auditor should inspect the lease agreement to find out the value and duration. The auditor should see that lease agreement is registered with the registrar and certificate testing to the validity of the same.

3. **Plant and machinery:**

   The Auditor should commence the process of verification by obtaining a schedule of plant and machinery certified by responsible officer of the concern.

Stock in trade:

It is practically impossible for auditor to physically verify each item of the stock in hand because of various reasons i.e. limited time and the lack of technical knowledge. Therefore the auditor has to rely upon test checks to ascertain the accuracy of stock in trade.

Investments:

The auditor should verify the details of the schedule of investment by applying tests e.g. financial journals and newspapers should be consulted for checking the market rates. The securities themselves may be consulted or the broker's notes may be examined for checking the cost etc.

The auditor should verify the amount of interest or dividends ass have already have been declared before the date of the balance sheet, should be taken into account as outstanding ones.

Capital:

In case of firm, the auditor should verify the liability on account of the capital with the help of partnership deed; pass book and the cash book.

In case of a company auditor should examine the memorandum of association to verify the information as to the maximum capital the company is authorized to raise. He should also ascertain the amount of called up in respect of each class of shares and also ascertain how many shares of each class are allotted as fully paid. Auditor should also specify the sources from which the bonus shares are issued i.e. capitalization of profits are reserves for share premium accounts. He should also ensure that capital profit, if any on issue of forfeited shares, has been transported to capital reserve.

Reserves and Funds:

The auditor should examine and verify that whether the decision to create reserve or fund is dictated by needs and circumstances of business and relevant legal provisions and check the relevant entries in books of accounts and check the entries passed for the purpose in the profit and loss appropriation account

Unit 4

Management and Tax Audit

MANAGEMENT AUDIT

Meaning and Definition

Management audit is attempt made to evaluate various management functions and process. A detailed and critical review of all the objectives, policies, procedures and functions of management is made with a view to bring about an overall improvement in managerial efficiency.

According to **Leslie R. Howard, "** An investigation of a business from the highest level downward in order to ascertain whether sound management prevails throughout, thus facilitating the most effective relationship with outside world and the most efficient organization and smooth running of internal organization."

According to **W.P. Leonard, "**A comprehensive and constructive examination of an organization structure of a company, institution or a branch of government or of any component thereof such as division or department, and its plans and objectives, its means of operations, and its uses of human and physical facilities."

Thus it can be simply stated that management audit, on the basis of established standards, examines, reviews and appraises the various policies and actions of management.

Objectives/Aims of management Audit

1. To ensure that sound objectives are set by the management.
2. To reveal any irregularity or defect in the process of management and to suggest improvements to obtain the best results.
3. To ensure that the management objectives are achieved.
4. To help various levels of management in the effective discharge of their duties.
5. To assist management in achieving coordination among various departments.
6. To help to achieve the efficiency of management.
7. To assist management in establishing good relations with the employees and to elaborate duties, rights and liabilities of entire staff.
8. To evaluate the performance by comparing inputs with outputs (human and physical both).
9. To ensure most effective relationship with the outsiders and the most efficient internal organization.
10. To recommend changes in the policies and procedure for a better future.

Advantages of Management Audit

1. It helps management in preparation of plans, objectives and policies and their efficient achievement.
2. It helps management in taking vital decisions for maximization of profits.
3. It helps the management in strengthening its communication systems within and outside the business.
4. It helps in evaluating the performance of management in various areas and measures to improve it.
5. It can help management in preparation of budgets and resource management.
6. It can help management in training of personnel and marketing policies.

Need/importance of Management Audit:

The statutory auditor is not required to examine the policies of management and their implementation or whether any improvement in the efficiency of management can be made. In these days a report on all these matters is very important to the business. The management auditors are appointed to advise the management on various matters related to management. These persons examine the various aspects of management and evaluate the actual performance by comparing it with predetermined standards. Such auditors may or may not be from the field of accountancy. They advise management on the matters relating to performance of various departments as well as of the organization as a whole.

The management may conduct management audit periodically to review the efficiency of managers. The results may be used to provide incentives to staff.

The management audit reveals irregularities and defects in the working of management and suggests the ways to improve the efficiency of management. It concentrates on the results and does not examine whether procedures have been followed or not.

The government may ask for management audit of sick industrial units with a view to examine the efficiency of management. It may be conducted to find whether the sickness is due to functioning of management or the circumstances beyond the control of management. On the basis of report of management auditor, the government may decide to take over to sick units.

It can be said that management audit is a guide which helps in improving the efficiency of management.

Appointment of Management Auditor

A team of experts should be appointed to conducted management audit. It can't be expected that an individual can possess expertise in all management's fields; therefore, an expert in each field of management should be included in the team of management auditors. Such team should have full cooperation from the top level management to enable it to conduct the audit smoothly.

The members of management audit team should have a proper training and expert knowledge of science of management. A wide experience of actual work situations will be added to the advantage. The audit of the management involves an appraisal of activities of organization; the auditor must study the organization and its plan in detail.

The internal auditors may be regarded as suitable persons for conduct of management audit because they are familiar with the internal workings of management. Sometimes it is desirable to have O & M experts as management auditors. All will depend on the scope of management audit which the management has to decide.

Qualities of a Management Auditor

The area of activities of management audit is wide; no specific qualities can be narrated for management auditor. He must possess enough qualities to fulfill his professional obligations. Some of the qualities of the management auditor can be described as follows.

1. He should have a good knowledge of managerial functions.
2. He should be familiar with the various principles of management, planning, control, management by objectives, and management by exception.
3. He should have a good understanding of financial statements and their preparations.
4. He should understand the working of organization and its problems.
5. He should be able to understand the objectives of organization.
6. He should be able to assess and critically examine the internal control systems.
7. He should be able to understand the nature of the product and its production process.
8. He should understand plans, budgets, rules and the procedures applied in the organization.
9. He should have a good knowledge of financial statement analysis techniques like standard costing, budgetary control, ratio analysis, fund flow statements etc.
10. He should be familiar with the human resources accounting, social accounting, etc.
11. He should have a good knowledge of economics, business laws, etc.

Management Auditor's Report

In the end, the management auditor prepares a report. On the basis of findings and definite information, the auditor prepares a report making suggestions for improvement in the working of the management. His report should give a correct assessment of the working of organization. He should not hesitate in criticizing the management. His recommendations should be constructive and not merely condemning in nature. His report may include the following matters:

1. Whether the management; and the staff relations are healthy.
2. Whether the return to shareholders is adequate.
3. Whether the methods of production are out-dated.
4. Comparison of operating efficiency of the organization with other concerns.
5. Rate of the return on investment.

Conduct of Management Audit

Following points need careful attention before he commences his work.

1. The auditor should ensure that various objectives and goals are properly established which are likely to help to achieve the desired results.
2. He should see that the plan laid down by management is practicable and helpful to achieve objectives.
3. He should see that whether the organization has a well defined structure, authority lines and responsibility areas are clear, decision making is centralized or decentralized.
4. He should verify the efficiency of information system operating in the organization.
5. To collect necessary information he should prepare a questionnaire such as:
    a. Whether the resources are efficiently employed,
    b. Whether plans, policies , procedures and systems are strictly followed
    c. Whether the objectives are split up into target of each department.
    d. Whether management by exception is possible.
    e. Whether the planned and actual performance are compared at regular intervals of time.
    f. Whether irregularities arise frequently, if so, who is responsible?
    g. Whether the methods used in organization are satisfactory.
6. The information obtained with the help of above questions should be counter checked from the various records and statements available in the organization.
7. To arrive at definite conclusions, the management audit has to correlate the information collected through various means.

Distinction between Management Audit and Statutory Audit

The statutory Audit is examining the accounts as per provisions of law but management audit is concerned with audit of performance of functions of management. Following are the points of difference

Management Audit	**Statutory Audit**
1. The management auditor examines the performance of management and makes suggestions to improve it in the future.	**1.** Statutory Audit reports on the financial aspects of an organization indicating whether financial statements show a true and fair view of state of affairs for a particular period.
2. The Conduct of management audit is optional and voluntary. There is no legal compulsion in this regard so far.	**2.** The audit of financial accounts is legally compulsory for a joint stock of company.
3. The management auditor is answerable to management only.	**3.** The Statutory auditor is accountable to the shareholders and authorities under the Act.
4. No qualification has been fixed for the management auditor.	**4.** The statutory auditor must be a Chartered accountant and emphasis is on independent report on financial matters.
5. The management audit is an aid to management.	**5.** It is a check on management.
6. The management audit may cover more than	**6.** It is conducted for a particular accounting

one financial year. **7.** The management auditor critically examines the past as well as looks to future activities of management. **8.** The management auditor's work begins where the work of statutory auditor ends. **9.** The management audit is concerned with making activities of management more effective and efficient.	period. **7.** The statutory reviews historical record only. **8.** The work of statutory auditor ends with reporting on financial records. **9.** It is not concerned with management' performance.

Tax Audit

Introduction

Now-a-days tax audit has become very important to ascertain the accuracy of tax related documents. Tax audit mostly covers income returns, invoices, debt and credit notes and various current and fixed assets. Tax audit is an innovation of 21st century. It has added one more chapter to the procedure of auditing. Tax audit ensures the validity and credibility of tax related documents.

The financial statements are certified by the auditor for truth and fairness of operating results and financial position of the business. These are meant for general purpose being used by the owners, creditors, banks and other interested parties. Sometimes a specific information my required by certain people which may not be available in these statements

Under Income Tax Act, profits shown by profit and loss A/c have to be adjusted as per the provisions of the Act. In this way profits for accounting and profits for taxation are not the same. These profits differ due to various reasons. Profits for accounting are ascertained As per accounting policies and standards but profits for the tax purpose are computes as per the provisions and rules of Income Tax Act.

The Income Tax Department cannot verify each and every detail of provisions compiled by the assessee. In this regard expertise of auditors is utilized, who certify the compliance of the provisions of Income Tax Act.

How to conduct tax Audit

1. The tax auditor shall be guided by the auditing standards and guidance notes as issued from time to time by Institute of Chartered Accountants of India.
2. Obtaining books of accounts, financial statements and other statements of particulars duly authenticated.
3. Evaluation of internal control system on the basis of which extent of vouching and verification can be determined.

4. While conducting tax audit the provisions and objectives of sec, 44 AB shall be kept in mind.
5. The auditor shall have thorough knowledge of taxation provisions and judicial pronouncements.
6. The Central Government has notified the following 'accounting Standards' in respect of audit of financial statements under section 44 AB.

Disclosure of accounting policies – AS (IT) I

Disclosure of prior period items, extra ordinary items and changes in accounting policies AS (IT) II

Both of these standards are similar to accounting standards issued by Institute of Chartered Accountants of India i.e. AS 1 and AS 5 except the points in standard issued by central government like application of standards to the assessee following mercantile system of accounting, standards include fund flow statement instead of cash flow statement, question regarding the changes in accounting policy may be referred to Central Board of Direct Taxes etc.

Compulsory Tax Audit

Following are provisions relating to compulsory audit under Section 44(AB) of income Tax Act.

I. Tax audit is compulsory for a business if its total sales, turnover or gross receipts in a previous year exceed Rs 1 crore.
II. In case of a profession, Tax audit is compulsory if gross receipt exceed Rs. 25 lakhs.
III. If the profits of a business are determined on presumptive basis, the audit of accounts shall be on compulsory basis if he assessee claims that their profits are less then profits computed under the following sections

A. Sec 44 (AD) –profit from any business (whether it is retail trading or civil construction or any other business)

Provisions are as follows

a. Assessee should be resident individual or resident HUF or resident partnership
b. Assessee has not claimed exemption under section 10 (A), 10 (AA), 10 (B), 10 (BA), 80 (HH) or 80 (RRB)

The following persons are not eligible

a. Person carrying on profession under [section 44 (AA) (1)]
b. The person earning commission or brokerage or carrying on agency business or plying, hiring or leasing goods carriage.
c. Turnover/gross receipt in the previous year should not exceed 1 crore

B. Profit from the business of carriage of goods [section 44 (AE)]

This sec is applicable to only those persons who are engaged in plying, hiring or leasing goods carriages and own not more than 10 such goods carriages.

C. Profit and gains of a non resident from shipping business [sec. 44 (B)]

A sum equal to 7.5% of the aggregate receipts in India shall be deemed to be the profit

If the assessee does not opt for the above scheme he will have to get accounts audited.

D. Profit and gain of business of Oil exploration of non-resident assessee [sec. 44 (BB)]

A sum equal to 10% of amount payable in India or outside India to assessee shall be deemed to the profit

If the assessee does not opt for the above scheme he will have to get accounts audited.

E. Profit and gains of business of operation of Aircraft by Non- resident[sec. 44 (BBA)]

A sum equal to 5% of amount payable in India or outside India to assessee shall be deemed to the profit

If the assessee does not opt for the above scheme he will have to get accounts audited.

F. Profit Of Foreign Company Engaged in Business of civil Construction or Erection of plant and machinery or/and Commission thereof[sec. 44 (BBB)]

A sum equal to 10% of amount payable in India or outside India to assessee shall be deemed to the profit

If the assessee does not opt for the above scheme he will have to get accounts audited.

iv. If Gross receipts or sales or turn over exceed a specified amount in a business only then audit is required.

v. Persons covered under section 44 (AB)

a. The persons who are not covered by Income Tax Act need to get their accounts audited for the purpose of this section like a person having agricultural income exceeding 40 lakhs.

b. The persons who are covered by this section but their income is exempted shall get their accounts audited as in case of charitable Trust, co-operative societies etc.

c. Persons, who are covered under this section, having income below the taxable limit, they have to get their accounts audited if the specified limit under section 44 AB has exceeded.

d. In case of non-resident assessee, if his global or receipts exceed the specified limit, then h has to get Indian operations accounts audited.

Vi. Persons not covered under section 44 AB

a. A non-resident assessee carrying business of operation of ship U/S 44 B.
b. A Non-Resident assessee having income from operation of aircraft u/s 44 BBA

vii. Specified date

The audit of accounts must be conducted and audit report must be submitted by the assessee by October 31.

VIII Penalty sec. 271 B

If any person fails to get his accounts audited as required u/s 44 AB, the assessing officer may direct such person shall pay a penalty equal to or .5% total sales, turnover or gross receipts in business or gross receipts in profession or Rs. 100000, whichever is less.

Meaning of Business

Business simply means any economic activity carried on for earning profits. Section2 (3) of Income Tax Act 1961, has defined term Business as, “Any trade, commerce, manufacture or any adventure or concern in the nature of trade, commerce and manufacture.” In the words of Justice S.R. Das, “The Word ‘Business’ connotes some real, substantive and systematic or organized course, activity or conducted with a set purpose.”

In This connection it is not necessary that there should be a series of transactions in business and also it should be carried on permanently. Neither repetition nor continuity of similartransactions necessary.

Meaning of Profession

A Profession is an occupation requiring purely intellectual skill or manual skill controlled by the intellectual skill of operator e.g. Lawyer, Accountant, Engineer, Surgeon etc. So profession refers tothose activities where livelihood by the persons through their intellectual or manual skill. Under section2 (6) profession includes vocation.

Vocation simply means any type of activity in which a person is engaged and he earns hi livelihood from such activity.

UNIT: 5

Audit of Institutions

Audit of Accounts of partnership Firms

To avoid any misunderstanding and doubt, partnership firms recognize the advantage of audit of financial statements. Partnership deed on mutual agreement between the partners may provide for audit of financial statements. Auditor is appointed by the mutual consent of all the partners. Rights, duties and liabilities of the auditor are defined in the mutual agreement and can be modified by partners. It will be in the interest of the auditor to get in writing the nature and scope of his work to avoid any dispute later on.

While conducting the audit of partnership firm the auditor must refer to the deed or Partnership Act 1932.

It is not legally compulsory to get accounts of partnership audited. The possibilities of mistrust and dissatisfaction are greater incase of partnership. An independent Auditor's view on the correctness of accounts is desirable in case of partnership concerns. Usually the partnership deed provides for the audit of accounts.

When partnership is silent, the following provisions of Partnership Act, 1932 will apply and auditor will take care of following points:

1. All partners will share profit or loss equally.
2. None of the partners will be entitled to receive any salary or remuneration.
3. Interest payable to partner on his capital, if any, shall be payable out of profits.
4. A partner contributing moneys in excess of agreed amount of capital will get interest at the rate of 6% p.a1
5. The partners shall use the property of the firm exclusively for the purposes of business.
6. A new partner can be admitted only with the consent of all partners.
7. Every partner has the right of access to the books of accounts and obtain a copy of the same.
8. A minor can be admitted to a firm for profits only.
9. When the other partners carry on the business after a partner ceases to be a partner due to death or for any other reasons without settlement of accounts between them, the outgoing partner or heirs of the deceased partner are entitled to either such share of profits attributable to his share in the property of the firm or interest at the rate of 6 % on his share in the property of the firm.
10. While settling the accounts of the firm on its dissolution, the goodwill of the firm will be considered as one of the assets of the firm. This goodwill may be sold separately or along with the other assets of the firm. Anyone or more partners will have the right to bid for the purpose of this goodwill.

11. On the dissolution of the firm, while settling the accounts, losses(including deficiencies of capital) shall be paid in the following order:
    a. Firstly, out of profits
    b. Secondly, out of capital and
    c. Lastly, by the partners individually in their profit sharing ratio.
12. On the dissolution of the firm, its assets, including any sums contributed by the partners to make up deficiencies, shall be applied in the following:
    a. Firstly, in paying debts of the firm to third partners.
    b. Secondly, in paying off proportionately to the partners their loans.
    c. Thirdly, if there is any balance, in paying proportionately to the partners towards their capital, and
    d. Fourthly, the balance, if any, shall be divided among the partners in their profit sharing ratio.

Advantages of audit of partnership firms:

1. It helps in detection and prevention of frauds or frauds or errors, and verification of correctness of accounts.
2. Any dispute between the partners relating to accounts can be settled by presenting independently audited accounts.
3. The periodical visits and suggestions by the auditor may prove to be helpful in improvement of management of the firm.
4. In case of admission, retirement or death of a partner, audited accounts are acceptable to all to adjust the accounts between the partners.
5. The audited accounts are helpful for income-tax assessment or for borrowing from the banks.

Consideration before the commencement of audit

1. He should have a contact with the client in writing. He should also have all the instructions and scope of audit in writing.
2. He should obtain a copy of partnership Deed. In case of no implied or expressed agreement between the partners regarding accounts, the provisions of Indian Partnership Act, 1932 relating to accounts will be applicable.
3. Before planning the audit programme, he should study the internal control system in operation.
4. He should study the system of accounting in operation and list of books maintained by the firm.
5. He should obtain list of members of staff, their duties, powers, and responsibilities.
6. He should make study of technicalities of the business of the firm to perform his job efficiently.

Company Audit

A company is said to be an artificial person created by law having a separate legal entity distinct from its members. It cannot be directly managed by its owners because they are very large in number have small holding and also scattered over a wide area. As such the management and control of the affairs of the company is done by directors but an absolute faith put in directors is not considered to be desirable on social and moral grounds. Hence, it becomes essential for a company to appoint an independent and qualified person i.e. an auditor, to verify and certify the truth and fairness of the financial statements.

Further, the companies usually work with a large staff and auditing serves a very useful purpose of locating all errors and irregularities in their work.

In order to achieve the above objectives, The Indian Companies Act 1956 has made it a statutory obligations for joint staff companies, whether public or private, to get their accounts audited by qualified auditor.

Statutory requirements governing the Company Auditors

Before commencing the audit work of company, the auditor should go through the following

1. **Ensuring Whether his appointment is in order:** Before commencing the audit work of a company the auditor shall ensure that all legal provisions relating to his appointment have been duly compiled with to ensure is appoint is in order. If his appointment is made in general meeting of the company, he should obtain the resolution of his appointment passed in such meeting. In case he has appointed in place of retiring auditor, he shall find out a due notice has been given to the retiring auditor in this regard. In case if the casual vacancy is due to resignation of the auditor, he shall obtain the copy of the resolution passed at general meeting making his appointment. He shall ensure that his remuneration has been fixed by the company as per the provisions of the Act.
2. **Inspection of Statutory Books and Documents:** Before the auditor commences the work of audit, he should examine the following documents
    a. Memorandum of Association.
    b. Articles of Association.
    c. Prospectus.
    d. Certificate of in cooperation and certificate to commence business

    He should also examine the following statutory books and registers.

    a. Register of Members. (Sec 88)
    b. Index of Members. (Sec 88)
    c. Register and Index of Debenture holders. (Sec 88)
    d. Register to Mortgages and charges (Sec 85)
    e. Register of Investment [sec 187(3)]

f. Foreign Register (Sec 88)
g. Register of Contracts (Sec 188, 184 and 189)
h. Register of Directors, managing Director , Manager and Secretary (170)
i. Register of Director's Shareholdings (170)
j. Register of Deposits (73)
k. Register of Loans (Sec [186(9)]
l. Minute books (118)

3. **Inspection of Contracts:** The auditor should inspect and examine the contracts which have been entered into by a company with other e.g.
    a. Contracts with the vendors of any property.
    b. Contracts with brokers and under writers for their commission.
    c. Contract with the promoters for the preliminary expenses, etc.

    If any statement regarding these contracts has been made by the company in the prospectus, the auditor should see that such statement is correct and that entries relating to such contracts are correctly recorded in the books of account.

4. **Study of Previous year's balance Sheet and Auditor's report:** the auditor should inspect the previous year's balance sheet to verify the opening balances of the current year. Moreover, according to Companies Act, the corresponding figures of the previous year have to be given in the balance sheet.

    The last audit report is inspected by the auditor mainly for two purposes.
    a. To formulate a rough idea about the company and its working.
    b. To see whether the recommendations made there in have been carried out or not.

5. **Study of the Internal Control System in Operation:** The study and evaluation of the internal control system in operation is important it serves as a basis there on. It helps the auditor in determining the extent of the tests to which auditing procedures can be restricted.

Audit Report /Auditor's Report

An auditor's Report is the format of result of all the effort that goes into the audit. Communicating the Auditor's findings to interested users is part of all audits. Thus, the Final phase of an Audit involves preparing that communication, which is known as auditor's report.

According to Lancaster, "Audit report is statement of collected and considered facts, so drawn up as to give clear and concise information to persons who are not already in possession of full facts of subject matter of the report."

It presents the results of the examination done by the auditor. An audit involves collection of evidence about the financial statements. The evidence collected needs to be carefully shifted and analyzed to enable the auditor to draw appropriate conclusions. The conclusions drawn are communicated to the interested parties through the auditor's report.

Contents of Audit Report

Under section 227 (2) every auditor is required to make report to the shareholders on the accountants examined by him and every balance sheet and profit and loss A/c and every document declared by law to be part of or annexed to the balance sheet and profit or loss A/C which are placed before the shareholders of the company at the general meeting during tenure of his office. The report has to state whether, in his opinion and to the best of his information and according to the explanations given to him, the said accountants give the information required by the Companies Act in manner so required and give a true and fair view.

i. In the case of the balance sheet, of the state of the company's affairs as at the end of its financial year; and
ii. In the case of profit and loss account, of the profit or loss account for its financial year.

Sub-section (iii) of the section 227 required that the auditor's report shall also state.

a. Whether he has obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit;
b. Whether in his opinion, proper books of account as required by law have been kept by the company so far as appears from hiss examination of these books, and proper returns adequate for the purposes of his audits have been received from the branches not visited by him .
c. Whether the report on the accounts of any branch office audited under section 228 by a person other than the company's auditor has been forwarded to him and how he has dealt with the same in preparing the auditor's report.
d. Whether the company's balance sheet and profit and loss A/C dealt with by the report are in agreement with the books of accounts and returns.

   If any of the matters as referred to in section 227 (2) and (3) is answered in the negative or with the qualification the auditor has to state in his report the reasons for such answer.

   The Auditor's report shall also include a statement on such additional matters as specified by the Central Government under section 227 (4-A) of the Companies Act, This section empowers the Central Government to order the inclusion of certain matters in the auditor's report.

   The Institute of Chartered Accountants of India requires the auditor's to ensure that the accounting standards are implemented in the presentation of financial statements covered by their audit reports. The deviation should be reported in the report.

Preparation/Matters to be included in the Audit Report

1. **Fixed Assets:**

   The auditor's report shall include statements on the following matters:

   a. Whether the company is maintaining the proper records showing particulars, including quantitative details and situations of fixed assets.
   b. Whether these assets have been physically verified by the management at reasonable intervals, whether any material discrepancies were noticed on such verification, and if so whether the same have been properly dealt within the books of accounts.
   c. If a substantial part of fixed assets has been disposed off during the year, Whether it has affected the going concern.

2. **Inventories:**

   The auditor has to make the following three specific statements on verification and valuation of inventories:

   a. Whether the physical verification of inventory has been conducted at reasonable intervals by the management.
   b. Are the procedures of physical verification of inventories followed by management reasonable and adequate in relation to the size of the company and the nature of its business? If not the inadequacies in such procedures should be reported.
   c. Whether the company is maintaining proper records of inventory and whether any material discrepancies have been noticed on physical verification and if so, whether the same have been properly dealt in within the books of account.

3. **Loans taken from/granted to parties covered under section 189:**

   The auditor ha to made four specific statements as under

   Has the company either granted or taken any loan, secured or unsecured to/from companies, firms or other parties covered in the register maintained under section 189 of the Act. If so give the number of parties and amount involved in the transactions.

   a. Whether rate of interest and other terms and conditions of loans given or taken by the company, secured or unsecured are primafacie prejudicial to the interest of the company
   b. Whether the payment of principal amount and interest are also irregular
   c. If overdue amount is more than 1 lakh, whether reasonable steps has been taken by the company for recovery/payment of principal and interest.

4. **Internal control on purchase of assets and sale of goods:**

   The auditor has to commit on the following:

   Is there an adequate internal control procedure commensurate with the size of the company and the nature of its business for the purchase of inventory and fixed assets and for the sale of goods?

   Whether there is continuing failure to correct major weaknesses in internal control.

5. **Maintenance of Cost Record:**

Whether the maintenance of cost records has been prescribed by the central government u/s 128 of the Act, Whether such accounts and records have been made and maintained.

6. **Indication of sickness:**

Whether in case of a company which has been register for a period not less than five years, its accumulated losses at the end of the financial year for not less than 50% of its net worth and whether it has incurred cash losses in such financial year immediately preceding in such financial year also.

7. **Documents and records for Secured loans:**

Whether adequate documents and records are maintained in case where the company has granted loans and advances on the basis of security by way of pledge of shares, debentures and other securities? If not, the deficiency to be pointed out.

8. **Guarantees for loans taken by other:**

Whether the company has given any guarantee for loans taken by others from bank or financial institutions, the Terms and conditions whereof are prejudicial to the interest of the company.

9. Disclosure of end use of money raised from public issue:

Whether the management has disclosed on the end use of money raised by public issue and the same has been verified.

10. Fraud:

Whether the fraud on or by the company has been noticed or reported during the year if yes the nature and the amount involved to be indicated.

Unqualified/ Clean/ Fair report:

When an auditor is satisfied with the fairness of the balance sheet and profit and loss account he will give a clean report. The auditor makes various statutory affirmations without reservations He is said to have the given an unqualified report on financial statements of the company.

Even when an auditor has given a clean report, it does not mean that it is absolutely accurate in other words the auditor is not guarantor of insurer as is observed by

Lord Justice lopes in re. Kingston cotton mills co. Ltd. Case, “auditor must not be held liable for not tracing out ingenious and carefully laid schemes or fraud, when there is nothing to arose their suspicion.”

Qualified Report:

If the auditor is of the opinion that the balance sheet does not give the true and the fair view of the state of company's affairs or, that profit and loss account does not give true and fair view of the profit or loss for the year he must qualify his report accordingly. When an auditor concludes on the basis of sufficient appropriate audit evidence that mis-statements are material but not pervaise to the financial statements or he is unable to obtain sufficient or appropriate evidence to conclude that financial statements are free from material mis-statements, such mis-statements remaining undetected may be material but not pervaise.